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THE DIRECTOR OF
CENTRAL INTELLIGENCE

National Intelligence Officers

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MEMORANDUM FOR: NSC Staff
Mr. Reginald Bartholomew
Mr. Robert King

FROM : Robert R. Bowie
Deputy to the DCI for National Intelligence

SUBJECT : Poland

In connection with your preparations for the 8 November PRC on policy options toward Poland, you may find this assessment of Poland's hard currency debt outlook and options useful. It was prepared by the Office of Economic Research here, and includes an annex on what is known about past Western experience in rescheduling of Eastern European debts (should that eventuality come about for Poland.)

[redacted] 25X1

Robert R. Bowie

Attachment

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October 1977

SUBJECT: POLAND:Hard Currency Debt

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POLAND: HARD CURRENCY DEBT October 1977

EXECUTIVE SUMMARY

Poland's net hard currency debt has grown from $2 billion at yearend 1973 to $10.2 billion by yearend 1976 as a result of its soaring trade deficits with the developed West. Although Warsaw had planned for a large increase in its debt, above-plan imports of Western capital equipment and grain together with recession in its Western export markets helped push Poland's debt up substantially more than expected. So far, Poland has been able to obtain the funds it needs to cover its trade deficits and meet growing debt repayments, but both Warsaw and some Western lenders are becoming increasingly concerned over Poland's growing debt burden.

Poland faces limited options over the next few years in managing its hard currency debt. Warsaw must continue to curb imports, but economic growth plans and consumer needs require large imports of Western machinery, industrial materials, and agricultural and food products. Rather than reduce growth targets substantially and make consumers tighten their belts, Warsaw probably will seek a large balance of payments loan from Western commercial banks and/or reschedule some of its debt to ease its financial difficulties. It is not clear when Poland will have to undertake such measures. But, the situation could warrant it in 1978, especially if Warsaw continues to have problems in controlling its trade deficit and has another poor harvest.

If a sizable balance of payments loan from Western commercial banks is insufficient to make ends meet, Warsaw may apply to one of the two CEMA banks for a loan. If that does not provide adequate relief, Poland might then seek to quietly reschedule a part of its debt with Western banks. This could be sufficient to bail Poland out, especially if Western economic recovery picks up steam. If not, Poland will be forced to reschedule its debt on government and government-backed credits.

Poland: Hard Currency Debt

Background

After taking power in late 1970, party leader Gierek instituted a program to push economic development and raise the workers' standard of living. To support this program, Poland has imported a large volume of machinery and equipment on credit as well as industrial materials from the West. To counteract consumer complaints over chronic meat shortages, Warsaw also has been forced to import substantial quantities of grain to support an expansion of livestock production and, in the past two years, to import meat. Soaring world prices -- particularly in late 1973 and 1974 -- for many of these imports added greatly to Poland's import bill.

Poland's exports to the developed West have not kept pace with imports, growing 23% a year since 1970 compared with almost 40% for imports. The relatively poorer export performance stemmed in large part from the Western recession in 1974-75 and its halting recovery in 1976. Meat exports were also reduced to augment domestic meat supplies. The ensuing trade deficits pushed Poland's hard currency debt from $800 million at yearend 1970 to $10.2 billion at the end of 1976. Debt service has grown and took an estimated 50% of merchandise exports to the developed West (see Table 1).

Table 1

Poland: Estimated Hard Currency

Balance of Payments

(Million US $)

	1974	1975	1976 1/
Exports, f.o.b.	2,865	3,026	3,330
Imports, f.o.b.	-5,233	-6,076	-6,660
Other Current Account	60	-125	-130
Current account balance	-2,308	-3,175	-3,460
Financed by			
Medium- and long-term credits, net	1,100	1,750	2,290
Short-term capital and errors and omissions	1,208	1,425	1,170
Outstanding net debt	3,950	6,873	10,200
Debt service ratio (percent) 2/	31	43	50

1. Preliminary.

2. Scheduled repayments of principal on medium- and long-term debt plus interest payments on total debt as a percent of merchandise exports to the developed West.

1977 Trade

Warsaw has attempted to bring its hard currency trade deficit under control but efforts to boost exports this year continue to be thwarted by sluggish Western economic recovery and soft world prices for Poland's major exports. Warsaw has had more success in holding down imports -- in part through import substitution -- especially of industrial raw materials. Import requirements from the West have been cut by a commitment of more Soviet oil until 1980 and last year's Soviet credit which probably have allowed Warsaw to shift some of its hard currency raw material purchases to the USSR.

Warsaw claims that its hard currency trade deficit was cut by one third in the first half of 1977, with exports rising 13% and imports falling 5%. These claims cannot be confirmed because Warsaw abruptly stopped publishing adequate trade statistics last March. Poland nevertheless is still behind its target of boosting the real level of exports by 20% this year.

Financing the Deficits

The rapid rise in Poland's imports of machinery and equipment was made possible for the most part by Western extensions of large amounts of government-backed credits.

By yearend 1976, the amount outstanding on government and government-backed credits represented one-third of total Polish indebtedness (see Table 2). Austria, France, the United Kingdom, and West Germany have been the largest sources of these credits -- accounting for roughly two-thirds of the total. West Germany also provided Poland with a \$425-million 20-year low-interest credit -- not tied to imports of West German goods -- in 1975. Poland's outstanding indebtedness on US government and government-backed credits at yearend 1976 totaled \$501 million, of which \$121 million was on Eximbank credits, \$166 million on CCC credits, and \$214 million on P.L. 480 credits extended during 1957-64.

Private borrowing from Western commercial banks has soared in large part because of Warsaw's need to take care of immediate financial needs arising from its large trade deficits and growing debt service payments. By yearend 1976, more than one-half of Poland's debt was owed to such banks.[1] In addition, Poland reportedly has received substantial Middle East deposits as well as loans from CEMA banks.

Because of the rapid buildup of its debt, Poland apparently began to experience the beginnings of a payments pinch in 1976. [redacted] 25X1

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1. Because much of this borrowing has been short-term, the share of long-term debt has dropped substantially from the estimated 60% in 1970.

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[redacted] by 1976 some US and West European banks had become reluctant to extend credits unless they were linked to a speicific project or had the backing of a major Western firm. [redacted]

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[redacted] Warsaw reportedly also encountered difficulties discounting commercial paper. Nonetheless the Poles were able to raise the necessary financing from commercial sources, although paying a higher interest rate than most other East European countries.

Outlook for 1977

Poland's trade deficit with the developed West in 1977 will be at least $500 million below the $3.3 billion recorded last year if current trends persist. Nevertheless, the financing required to cover the deficit and meet debt service obligations will be close to $5 billion this year. Warsaw has available for use this year about $2 billion in government and government-backed credits. In addition at the beginning of the year there were $1.2 billion in unused private bank credits. The remainder of its financing will have to come through commercial bank borrowing. So far this year, Poland has not encountered serious difficulties in raising funds, although it may be paying higher interest rates.

Beyond 1977

Poland faces limited options over the next few years in trying to manage its hard currency debt. Warsaw must continue to curb imports, but economic growth plans and consumer needs require large imports of Western machinery, industrial materials, and agricultural and food products. Warsaw already has announced its intentions to curb imports of Western machinery and equipment in 1978-80. Such imports can be curtailed for a time without much effect on economic growth because there is a large backlog of equipment not yet delivered or operating and some plant already in place is underutilized. If, however, recovery in the West remains sluggish, Warsaw will have to make further cuts -- especially in industrial raw material imports -- and, as a result, reduce its economic growth targets. Continuing poor harvests -- Poland has had four in a row -- would make a reduction in growth plans even more likely.

Poland's hard currency imports are now double exports. Thus, even under favorable circumstances -- a strong recovery in exports, good harvests, and zero import growth -- Poland will not be able to achieve the goal of balancing its trade with the West by 1980. Consequently, Poland's financing requirements -- to cover the expected trade deficits and debt repayments -- will approach \$4 billion to \$5 billion each year. The more or less constant level of financing stems from the fact that rising debt repayments will to a large extent offset the expected decline in trade deficits.

Most will have to be raised in Western money markets since only about $2 billion a year is expected to be drawn on Western government and government-backed credits.

Prospects for Debt Relief

To ease its financial difficulties, Warsaw has available a number of options. Warsaw may:

- Continue to seek concessionary credits from Western governments;
- Seek a large balance of payments loan from Western commercial banks in order to meet debt repayments;
- Obtain funds from one or both CEMA banks;
- Reschedule some of its debt with Western commercial banks;
- Reschedule a substantial part of its debt owed to Western governments; or
- Seek some combination of these.

So far this year, Warsaw has approached both West Germany and the United States for extraordinary concessionary credits. The Poles sought a $1 billion financial credit -- not tied to imports -- from Bonn in exchange for future deliveries of Polish electricity to West Germany. The West Germans did not reject the Polish proposal, but deferred considering it because of the present political climate in West Germany. In September

Warsaw asked for a $500-$600 million credit from the US to finance its agricultural purchases in FY 1978. In addition, it is seeking $400-$500 million thereafter for similar purchases. The Poles want a seven-year repayment period on the credits, including a three-year grace period. Such terms are highly unusual on financing of agricultural purchases -- which rarely exceed three years. Poland also may have approached France, Austria, and Belgium for concessionary credits during recent high-level contacts with leaders of these countries. Moreover, party leader Gierek could seek Italian assistance during his November trip to Rome.

To meet some of its debt obligations in 1978-79, Warsaw reportedly will also seek a $700 million syndicated balance of payments loan early next year -- a move some US bankers have urged Warsaw to take. Although a large untied loan would indicate Warsaw's severe payments difficulties [redacted] 25X1

25X1 [redacted] Poland would be able to obtain the loan if the financing terms were attractive. Many Western bankers are still confident -- despite the fact that Poland will have some rough sledding over the next few years -- that the long-term outlook for the Polish economy is good. Western money markets in any case are now characterized by excess liquidity; hence Western banks are looking for borrowers for the time being.

It is doubtful, however, whether Warsaw would accept, at least initially, a large balance of payments loan if it considered the terms too burdensome. In recent months, Poland has demanded lower rates on its borrowing because of the current excess liquidity in Western capital markets. Western bankers, however, would probably place a high price on any large untied loan for balance-of-payments purposes. As a precondition for a loan, bankers also would require much more financial information than Warsaw has been willing to divulge in the past.

If it believed a large balance of payments loan too costly in terms of the interest rate, front-end fees, or repayment period, Poland might prefer to ask one or both CEMA banks for a hard currency loan. The money could be borrowed by these banks from Western banks on behalf of Poland -- although not publicly announced. Various scenarios which would conceal the ultimate borrower are possible. Warsaw could also quietly approach individual Western banks to whom it is heavily in debt for rescheduling.

If these prove to be unworkable, the Poles might opt for refinancing Western government and government-backed loans. Such an approach would probably cut down on the transaction costs of dealing with a large number of banks but it would be a public admission that Warsaw was experiencing severe financial difficulties.

In the event that Poland tries to reschedule its Western government debts, it probably would turn first to Austria, France, or the United Kingdom because of the large amount of government-backed debt outstanding and the excellent political relations Warsaw has with these countries. [redacted] 25X1

25X1 [redacted]

Warsaw probably will be reluctant to approach the West Germans because of Bonn's past extensions of large financial assistance. Poland might also hesitate to turn to the US for rescheduling because it already have asked for concessionary credits to finance purchases of agricultural imports.

As a last resort, Poland may rejoin the IMF to obtain balance of payments assistance. However, such a more would require Soviet acquiescence as well as Poland's acceptance of a probing IMF analysis of its economy. In any case, because of the lengthy negotiations required to join the IMF, Poland probably would not be eligible for any financial assistance before 1980.

Whatever approach or combination of approaches Warsaw might take to ease its financial burdens, major rescheduling or borrowing could take place as early as next year and possibly by 1979.[2/]

2. For a discussion of the Romanian and Yugoslav experiences with debt rescheduling, refer to the Appendix.

Table 2

Poland: Provisional Estimate of the Structure of the Net Hard Currency Debt at Yearend 1976

(Million US $)

Total	10,200
Private credits from Western commercial banks	5,800
Western government and government-backed 1/	3,640
Other	760

1. Of this amount, France, West Germany, and the UK each account for roughly one-fifth, whereas Austria, Italy, Japan, and the US each account for less than 10 percent.

APPENDIX

East European Rescheduling and Refinancing

Romania and Yugoslavia have both renegotiated their debts in the past, but they did so exclusively with government and other official institutions, which held nearly all of the debt. The Polish situation is somewhat different because a substantial part of the debt is on private commercial bank credits. We believe, therefore, that Warsaw would approach the banks for a balance of payments loan -- if the cost was not too high -- before approaching Western governments. If necessary, however, Poland probably would go to Western governments. But, unlike Romania, which depended heavily on West German assistance, we believe that Poland would be less likely to approach West Germany than it would Austria, France, or the United Kingdom since Bonn has indicated a reluctance on this score. But if the Poles were to go to the West Germans, Bonn might [redacted] 25X1

25X1 [redacted] insist on a multilateral rescheduling. When Yugoslavia requested rescheduling in 1970, the United States, a major creditor, apparently made rescheduling assistance contingent on sufficient help from West Germany.

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The International Monetary Fund

Romania -- the only East European country except Yugoslavia that is a member of the IMF -- has also received some balance-of-payments assistance from the Fund. In November 1973 and October 1975, Romania obtained special drawing rights from the Fund's general account for SDR 47.5 million and SDR 95 million, respectively. In April 1976, the IMF granted Romania SDR 95 million under the decision on the Compensatory Financing of Export Fluctuations. In June 1976, Bucharest obtained an extension on repurchases due on a gold tranche and on the special drawing rights drawn on in 1973. In September 1977, Bucharest again requested compensatory financing equivalent to SDR 47.5 million.

Yugoslavia

In late 1970 -- realizing it would be unable to finance its large hard currency trade deficit and meet debt obligations falling due in 1971 -- Belgrade began to press for financial assistance. Its major creditors -- the United States, Italy, West Germany, France and Japan -- along with the IMF, agreed to come to its assistance. The United States agreed to reschedule $58.5 million in PL 480 and AID payments falling due in 1971-72. Repayment was at a 5% rate of interest. Apparently the United States made the rescheduling contingent on satisfactory assistance from the West Germans. Italy agreed to divide rescheduling into three $25 million portions for the period 1972-74. The West German government provided a financial credit of roughly $93 million and the French government agreed to supply about $20 million to cover Yugoslav debt obligations. Belgrade also received an $83.5 million standby credit from the IMF after assuring the Fund that it would take steps to check the volatile growth in credits guaranteed by Yugoslav business banks.